BEFORE THE INSURANCE COMMISSIONER
FOR THE STATE OF DELAWARE

In Re: The Proposed Affiliation of	)	
BCBSD, INC., doing business as	)	Docket No. 1509-10
Blue Cross Blue Shield of Delaware,	)	
with HIGHMARK, INC.	)	

PRE-HEARING MEMORANDUM OF THE
DELAWARE DEPARTMENT OF JUSTICE

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I. PRELIMINARY STATEMENT

The current proceedings relate to the proposed affiliation of BCBSD, Inc., a Delaware nonstock general business corporation licensed as a nonprofit health service corporation pursuant to 18 *Del. C.* §§ 6301 *et seq.* ("BCBSD"), the largest Delaware health insurer and the only significant health insurer in Delaware that is locally controlled, with a Pennsylvania corporation. BCBSD is also the sole holder of the Blue Cross and Blue Shield marks in Delaware. The Attorney General of the State of Delaware (the "AG" and, together with his staff at the Delaware Department of Justice, the "DOJ") is a party to these proceedings in his capacity as *parens patriae* to protect the public interest.

The DOJ has reviewed the Proposed Affiliation (as defined herein) and opposes it because it will transfer control of BCBSD out of Delaware to Pennsylvania and because it will not adequately protect the historic subsidy the Delaware public has provided to BCBSD.

Accordingly, the DOJ will recommend disapproval of the Proposed Affiliation unless the assets accumulated by BCBSD as a result of the public's subsidy of it are protected as described below:

> BCBSD and Highmark must establish a mechanism to guarantee that the public's investment in BCBSD remains in Delaware to be held and protected for the benefit of Delawareans, specifically to serve the State's unmet health needs, particularly with regard to medically uninsured and underserved populations. A foundation based on the parameters set forth in 29 *Del. C.* § 2533 would obviously be one way to meet this objective, but perhaps not the only way. The public investment Delawareans have made in BCBSD should be valued prior to the closing of the transaction, taking into account the effect of the affiliation, by a valuation expertapproved by the Department of Justice, but the asset that shall be contributed to the foundation should in no event be less than $45 million. Nothing in this condition shall be construed to limit, now or in the future, with respect to a conversion or otherwise, the authority of the Attorney General under the Delaware Code or common law to protect the

> charitable trusts and assets of BCBSD held for the public benefit in this State.
>
> *(Letter from Attorney General Joseph R. Biden, III, to Frederick Campbell and David Swayze, dated September 21, 2011.)*

Thus, the required mechanism must reflect the value of the public subsidy of BCBSD, which must be no less than, but could be greater than, $45 million. Establishment of this mechanism will not affect the DOJ's duty to protect the public benefit asset in a subsequent conversion. The DOJ has made this requirement known to the Applicants, as defined below, and to the Delaware Department of Insurance (the "DOI") in a letter dated September 21, 2011, which is attached to this memorandum as Appendix A (the "DOJ's Opposition Letter").

II. STATEMENT OF FACTS

a. Background

On October 7, 2010, Highmark Inc., a Pennsylvania nonprofit corporation ("Highmark"), filed with the DOI a Statement Regarding the Affiliation of BCBSD, Inc. with Highmark Inc. (the "Statement") concerning a Business Affiliation Agreement (the "Affiliation Agreement") entered into on August 19, 2010 by and between Highmark and BCBSD. The Statement seeks the approval of the Delaware Insurance Commissioner (the "Commissioner") of the Affiliation Agreement and for Highmark and BCBSD (together, the "Applicants") to enter into the transactions and to take the corporate actions contemplated thereby (the "Proposed Affiliation").

As described in the Statement, the Proposed Affiliation is framed not as an acquisition, merger, conversion, stock purchase, asset purchase or consolidation, but rather as an affiliation. *In fact, it will constitute a change of control whereby Highmark will become the sole member of BCBSD and the licensee of the Blue Cross and Blue Shield marks in Delaware. BCBSD, for its part, will become a controlled affiliate of Highmark under Delaware law and within the meaning of the rules of the Blue Cross Blue Shield Association.*

In order to accomplish the Proposed Affiliation, BCBSD's Certificate of Incorporation and Bylaws will be amended to grant Highmark an increasing level of control over the BCBSD Board of Directors. See pp. 3-4 of the Statement. Pursuant to the Certificate and Bylaws, the BCBSD Board of Directors will be comprised of nine directors. Four directors will constitute the "Class A Directors" who must at all times be independent of Highmark. Another four directors will constitute the "Class B Directors" who, for the first three years after the closing of the Affiliation, will include the chief executive officer of Highmark and two other executive officers of Highmark as well as one person appointed by Highmark who is not employed by BCBSD or Highmark and who has been a resident of Delaware for at least five years. The ninth director will be the President of BCBSD, who can be dismissed without cause by the Class B, *i.e.*, Highmark-appointed, Directors. While the initial Class A Directors will be designated by BCBSD, all subsequent Class A Directors will be elected by Highmark, as BCBSD's sole member, from persons nominated by a Nominating Committee comprised of the Class A Directors.

The Affiliation Agreement contemplates that BCBSD and Highmark will enter into an Administrative Services Agreement whereby Highmark will provide services at cost to BCBSD, and BCBSD will be allocated a share of the costs for a broad range of expenses including Highmark's administrative overhead. Highmark will provide an unsecured line of credit of up to $45 million to help defray costs associated with BCBSD's migration to Highmark's information technology platforms and systems. BCBSD has repeatedly cited substantial savings in vendor services and IT investment as one of the primary reasons for the Proposed Affiliation.

b. Procedural History

Highmark filed the Statement with the DOI on October 7, 2010. The Applicants and the DOI had previously agreed that while BCBSD, as a health service corporation, is not subject to 18 *Del. C.* §§ 5001 *et seq.*, the "Delaware Insurance Holding Company Registration Act" (the "HCA"), Highmark would submit the Statement to the DOI in the form of a request for approval *of a change of control of BCBSD* under the HCA pursuant to the DOI's general regulatory authority over BCBSD under 18 *Del. C.* §§ 301 *et seq.*

In a Pre-Hearing Order issued by the Commissioner on October 20, 2010, the DOI, Highmark and BCBSD agreed that the AG, representing the State of Delaware (the "State") in his capacity as *parens patriae*, is also a party to these proceedings. (Pre-Hearing Order, ¶ 4). The AG's participation in these proceedings was recognized to be "without prejudice to any separate rights the Attorney General may possess and may elect to pursue in other venues which are otherwise available, as a matter of law." *Id.*

The DOJ engaged Grace Global Capital, LLC ("Grace Global"), as financial consultants, and Dewey & LeBoeuf LLP as legal consultants (together, the "DOJ Consultants"), to assist in its review of the Proposed Affiliation. On May 31, 2011, the AG issued a letter notifying BCBSD that the DOJ had concluded that the Proposed Affiliation constituted a not-for-profit healthcare conversion transaction under Section 2531(1)(c) of the Delaware Not-for-profit Healthcare Conversion Act, 29 *Del. C.* §§ 2530 *et seq.* (the "Conversion Act") and that, accordingly, a tax-exempt public benefit or charitable organization or foundation would be required by law to be established pursuant to 29 *Del. C.* § 2533 for "proceeds or reserves" of the conversion transaction that constitute "public benefit assets". The letter is attached as Appendix B. The Conversion Act was subsequently amended, effective July 12, 2011, so that the Proposed Affiliation would no longer constitute a conversion. Furthermore, pursuant to 18 *Del. C.* § 6311, which was enacted as part of that amendment and which is within the Delaware Health Service Corporations Act ("HSCA Section 6311"), the DOI's review of the Proposed Affiliation is now expressly governed by the change of control provisions of the HCA as well as other specific requirements found in HSCA Section 6311.

This memorandum, which sets forth the position of the DOJ with respect to the Proposed Affiliation, is being submitted in accordance with the Scheduling Order issued by The Honorable Battle R. Robinson as Hearing Officer on August 5, 2011. The DOJ and the DOJ Consultants have met with the Applicants and have reviewed documents made available to them.

III. DISCUSSION

a. The DOJ Represents the People of Delaware at the Hearing and Therefore Is Authorized to Make Recommendations to the Hearing Officer as to Whether, or Subject to What Conditions, the Statement Should Be Approved.

The AG has *parens patriae* authority, as affirmed by 29 *Del. C.* § 2533(k) and acknowledged by the parties, to protect the interests of the public.

As stated above, the parties to the Proposed Affiliation and the DOI acknowledged early in these proceedings that the AG, "representing the State in its capacity as *parens patriae*," is a party to the DOI's review process, separate from any other authority he possesses. The modern test for *parens patriae* standing articulated by the United States Supreme Court is that the State must assert a "quasi-sovereign interest," meaning "interests that the State has in the well-being of its populace." *Snapp v. Puerto Rico ex rel. Barez*, 458 U.S. 592 (1982). One type of recognized interest is the State's interest in the health and well-being – both physical and economic – of its residents in general. As discussed below, this interest is broader in scope than the DOI's review standard under the HCA. Indeed, in transactions previously proposed by BCBSD prior to the enactment of the Conversion Act, the AG had asserted jurisdiction to represent the people of Delaware pursuant to his *parens patriae* standing.[1]

The July 2011 amendment of the Conversion Act changed only the DOJ's authority to review a change of control transaction between two not-for-profit entities as a conversion requiring a foundation under the Conversion Act. It does not change the DOJ's authority to review every transaction involving a not-for-profit healthcare entity as *parens patriae*, whether or not it is a conversion and whether the transaction or the DOJ's review is pursuant to the Conversion Act or otherwise. The amendment also does not limit in any way the AG's *parens patriae* or *cy pres* authority under common law or other statutes. To the contrary, Section 2533(k) of the Conversion Act, which was not changed by the July 2011 amendment, provides that nothing in the Conversion Act "shall be

[1] A Delaware court has stated that the AG is usually a necessary party, under *parens patriae*, to any suit involving the existence or administration of a charitable trust, which could be construed to include this administrative proceeding involving BCBSD, as at least some portion of BCBSD's reserves constitute assets held in charitable trust having accumulated as a result of BCBSD's historic charitable intent. *See Trustees of New Castle Common v. Gordy*, 91 A.2d 135, 135 (Del. Ch. 1952).

construed to limit the common law authority of the Attorney General to protect the charitable trusts and assets held for the public benefit in this State...[or] shall be construed as a replacement for any other civil or criminal actions, which the Attorney General may take either under the common law or statutory law, seeking injunctive relief, or other available remedies." Thus, it remains the DOJ's duty to protect "the charitable trusts and assets held for the public benefit in this State" that represent the public subsidy of such entities, including in conversions and also in other transactions such as the change of control that will occur in the Proposed Affiliation. That a foundation is not statutorily mandated as it would be in a conversion does not limit the ability of the DOJ to find one to be necessary to protect the public interest where control of the not-for-profit and its assets is changing, as here.[2]

The July 2011 amendment to the Delaware Health Service Corporations Act, which added HSCA Section 6311, provides statutory support to what had been the agreement of the parties to the Proposed Affiliation that a change of control of a not-for-profit healthcare entity such as BCBSD that involves another not-for-profit entity can be reviewed under the HCA by the Commissioner. New HSCA Section 6311 also acknowledges the AG's ongoing *parens patriae* jurisdiction insofar as it separately requires notification to the DOJ of activities after such a transaction that require the approval of the DOI including, without limitation, (i) any change in the certificate of incorporation and (ii) "any individual expenditure or transfer of funds or coordinated series of expenditures or transfers of funds by [BCBSD] in excess of $500,000 to the controlling entity or any affiliate of such controlling entity" and (iii) *pursuant to any other conditions imposed by the Commissioner.* 18 *Del. C.* § 6311(b). HSCA Section 6311(d) also provides that upon a dissolution of a not-for-profit healthcare entity, the assets remaining after the discharge of all of its obligations will be distributed to a charitable foundation to be created under Section 2533 of the Conversion Act.

Thus, notwithstanding the fact that under the Conversion Act as amended in July 2011, the Proposed Affiliation is no longer a not-for-profit healthcare conversion transaction, BCBSD remains a *not-for-profit* healthcare entity, the continuing protection

[2] Nor would the finding of a foundation to be necessary in this transaction in any way limit the DOJ's calculation of the public benefit asset at the time of a future conversion of BCBSD to for-profit.

of which is the intent of the Conversion Act as well as the Delaware Health Service Corporations Act. It is the DOJ who has the responsibility of protecting the public interest in, and the assets created through the public subsidy of, BCBSD as a not-for-profit entity. The AG is considered to be standing in the shoes of the citizens of Delaware, and as such is vested with the authority and the duty to represent them with respect to a change of control of such an entity, opposing the change of control if he deems that appropriate and seeking conditions he considers necessary to protect the public interests if the transaction is consummated.

The DOJ is the protector of the BCBSD public benefit asset created by public subsidy over 75 years.

The Delaware public has provided a substantial subsidy to BCBSD. BCBSD has benefited significantly over more than seven decades from favorable tax treatment due to its status as a not-for-profit under Delaware law, and that status has also afforded it other advantages in terms of public perception, good will and market dominance. It is the DOJ's responsibility to protect the public's subsidy for the people of Delaware.

BCBSD was founded in 1935 as a nonstock, not-for-profit corporation. The State has historically granted favored tax treatment, thereby foregoing revenue, to those corporate entities that work to serve, benefit and promote the public good. For more than 75 years, BCBSD enjoyed this favored tax treatment, as well as the good will and positive public perception generated by its not-for-profit status. Each of these factors has played a part in BCBSD's attainment of its current market dominance and its strong financial position, including the build-up of capital and surplus in Delaware that is higher than average for a plan of its size and the highest in the company's history. As noted in the DOJ's Opposition Letter (Appendix A):

> BCBSD's current reserves of approximately $181 million are more than five times what the National Association of Insurance Commissioners requires and more than three times what the Blue Cross Blue Shield Association requires. The minimum amount of $45 million proposed would leave BCBSD with over $135 million in remaining reserves, and

> would not jeopardize the amount of Risk Based Capital ("RBC") that BCBSD would need to maintain to be well above the Blue Cross Blue Shield Association's recommended minimum (375% of RBC) and the National Association of Insurance Commissioner's mandatory minimum (200% of RBC). In addition, it would be very close to the average RBC far similarly situated Blue plans (902% in 2010). $135 million in remaining reserves would leave BCBSD with approximately 820% of RBC.
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> *(DOJ's Opposition Letter.)*

The mission of not-for-profit healthcare companies has been clarified by statute: the Conversion Act specifically requires that upon a conversion of such an entity, the portion of the fair market value of the converting entity "impressed with a public trust for the public benefit" shall be deposited into a foundation "serving the State's unmet health needs...." 29 *Del. C.* §§ 2531(5) and 2533(a) and (b). HSCA Section 6311(d) requires the same result upon dissolution of such an entity. Given that the law thus recognizes the public trust with which such funds are impressed and earmarks them for public benefit purposes upon conversion or dissolution, obviously the intent is that the same funds should be used in the pursuit of such purposes while they remain in an unconverted not-for-profit healthcare entity. Thus, the State expects that not-for-profit healthcare entities like BCBSD will use the Delaware public's subsidy of them, which is directly attributable to such entities' not-for-profit status, to serve the unmet health needs of Delawareans. The DOJ's opposition to this transaction is based on Delaware losing control of this important health insurer and the substantial public subsidy it represents.

There is no denying that the ultimate control of BCBSD, and therefore of the assets representing the public's subsidy of BCBSD, is being shifted outside of Delaware. Describing the Proposed Affiliation as an "affiliation" simply fosters the illusion that it is not a change of control. In reality, if this transaction is approved, Highmark, a much larger insurer based in Pittsburgh and not licensed or doing business in Delaware, will control BCBSD. Highmark will be the sole member of BCBSD, and the holder of its Blue marks. Highmark's appointed directors will fill nearly half of the seats on BCBSD's Board of Directors, and Highmark's appointed directors will not need the vote of a single non-Highmark-appointed director in order to dismiss BCBSD's president, who is also a director, without cause, while BCBSD will not have any representation on

Highmark's management or Board. BCBSD will be responsible for paying part of various home office expenses, including the compensation of Highmark's senior management, but there is no formal agreement in place regarding how these and other costs will be allocated among the various affiliates in the Highmark group, which will include BCBSD. Thus, BCBSD will be controlled from Pittsburgh, where the needs of, and benefit to, Delawareans will not necessarily come first.

Not only will the control of BCBSD and its assets be shifted outside of Delaware, but control will be vested in an entity that is not subject to the direct supervision of a Delaware agency. As a Pennsylvania health service corporation that is not licensed or doing business in Delaware, Highmark will not be subject to regular examinations by the Delaware DOI and is not required to comply with relevant portions of Delaware law.

Under these circumstances, the DOJ lacks confidence that each Highmark decision involving BCBSD assets will be focused exclusively on BCBSD, its policyholders and the citizens of Delaware, or that preservation in Delaware and for Delawareans of those assets representing the public subsidy of BCBSD by the citizens of Delaware will be Highmark's priority. Accordingly, the DOJ opposes the transaction and recommends disapproval unless, at a minimum, BCBSD and Highmark establish a mechanism to guarantee that the assets accumulated through the public's subsidy of BCBSD remain in Delaware to be held and protected for the benefit of Delawareans. The DOJ considers a foundation such as the one described in the Conversion Act and mandated for conversions and dissolutions of not-for-profit health service corporations to be the most effective way to safeguard Delaware's decades-long subsidy of BCBSD upon its change of control to Highmark.

The July 2011 amendment of the Conversion Act did not change 29 *Del. C.* § 2533(k); to the contrary, it reaffirmed Section 2533(k) of the Conversion Act through enactment of HSCA Section 6311. The July 2011 amendment also did not prohibit the creation of a foundation in connection with a transaction that is not within the amended statutory definition of a "conversion". It merely removed the statutory *requirement* that such a foundation be created pursuant to and in the form required by the Conversion Act for a transaction that is neither a conversion nor a dissolution.

The DOJ's role differs substantially from the DOI's role.

Unlike the AG's broad *parens patriae* duty and authority to protect the general public and the assets accumulated as a result of the public subsidy of BCBSD, the DOI's responsibilities in reviewing the Proposed Affiliation are those set forth in HSCA Section 6311 and, by reference therein, the HCA. HSCA Section 6311(a) requires that the approval of a change of control of BCBSD to another not-for-profit entity, as well as its ongoing management post-affiliation, shall be governed by the HCA except where other applicable provisions of the Insurance Code or conditions imposed by the Commissioner effect more stringent requirements. HSCA Section 6311 imposes a number of conditions, discussed below, and anticipates that the Commissioner could impose others. The DOJ recommends disapproval by the Commissioner under the HCA unless the additional condition proposed by the DOJ to protect the assets accumulated through the public subsidy of BCBSD is imposed.

The statutory framework of the HCA requires that the Commissioner approve a change of control unless the DOI makes certain findings, which relevantly include, among others, the following:

> (i) the plans or proposals which the acquiring party has to liquidate the insurer, sell its assets or consolidate or merge it with any person, or to make any other material change in its business or corporate structure or management, are unfair and unreasonable to *policyholders of the insurer* ***and*** *not in the public interest*; or
>
> (ii) the acquisition is likely to be hazardous or prejudicial to the insurance buying public.
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> 18 *Del. C.* §§ 5003(d)d, f (emphasis added).

The Commissioner also retains supervisory responsibilities following an approved change of control, which include ensuring ongoing compliance with the provisions of the HCA as well as the authority to enforce the conditions imposed by statute and by order. *See* 18 *Del. C.* §§ 6311(a), (c). The HCA does not limit the Commissioner's authority to impose conditions; to the contrary, HSCA Section 6311 expressly anticipates that the "insurance buying public" or where proposed business changes are "unfair and unreasonable to policyholders of the insurer" *and* not in the public interest. The DOJ's standard of review is not similarly limited: it protects the interests of all the citizens of Delaware and the assets accumulated through the public's subsidy of not-for-profit entities. Therefore, the DOJ's role extends beyond the impact of a change of control on the insurance buying public or policyholders to matters beyond the clear purview of the DOI, including the impact on the public as a whole as to matters that would not trigger the DOI's protection (*e.g.*, protection of the assets accumulated through the public's subsidy). Even where the authority of the DOJ and the DOI overlap, the DOJ must consider whether *parens patriae* requires protection that goes beyond, or is different from, that provided by the DOI.

A comparison of the Conversion Act and the AG notice provisions in HSCA Section 6311 serves to highlight certain areas of concern to the DOJ that are not addressed in HSCA Section 6311. HSCA Section 6311 provides, among other things, that transactions such as the Proposed Affiliation are expressly governed by the HCA, and requires that joint notice be given to the DOI and DOJ under certain circumstances. The Conversion Act includes a "*substantial change* ***or*** amendment to a certificate of incorporation *which materially affects an entity's charitable or public benefit intent...*" as a trigger requiring notice to be given to the DOJ. *See* 29 *Del. C.* § 2531(1)(c). HSCA Section 6311 requires notice to be provided to the DOJ where there is a change to the certificate of incorporation, but it fails to require notice in connection with other changes that could affect BCBSD's charitable or public benefit intent or the assets accumulated through the public's subsidy of BCBSD. *See* 18 *Del. C.* §6311(b)(1). Under the doctrine of *cy pres*, where a charitable trust will no longer be used as originally intended, the AG has standing in a court action to ensure that the trust is used for purposes as close as possible to the original intent. In Delaware, Section 3541 of the Decedents' Estates and Fiduciary Relations Code, which codifies the doctrine of *cy pres*, provides that if a charitable trust no longer serves its charitable purpose, the Delaware Court of Chancery has jurisdiction to modify it or terminate it and distribute its assets in a "manner consistent with the trustor's charitable...purposes." If there were to be a change in a charitable trust such that it no longer served the original charitable purpose, the DOJ

Commissioner may impose conditions that go beyond and supersede the HCA in order to ensure compliance with HSCA Section 6311. Such conditions would be imposed to ensure compliance with, among others, HSCA Section 6311(b), which requires that the Commissioner impose conditions intended to preserve "that amount, determined in accordance with Delaware law, that constitutes the surplus or reserves of the health service corporation." Although the statute identifies certain conditions that must be imposed to preserve that amount, it specifically allows for others, which do not preclude the establishment of a foundation, to be imposed in furtherance of that objective. Furthermore, the DOI has in fact identified conditions it is recommending be imposed that are not specifically required by the HCA or HSCA Section 6311 but rather represent the DOI's interpretation of how to ensure compliance with those standards of the HCA that relate to the insurance buying public and the public interest. The accumulation of the substantial surplus or reserves of BCBSD has been subsidized by the people of Delaware. Accordingly, the Commissioner may impose conditions, such as the condition required by the DOJ, that go beyond the traditional scope of the HCA or the explicit requirements of HSCA Section 6311 to protect the surplus or reserves of BCBSD. *See* Pre-Hearing Memorandum of the Delaware Department of Insurance, filed September 21, 2011.

HSCA Section 6311(b) imposes a statutory condition that will govern the composition of BCBSD's Board and another that will require BCBSD to consent to the ability of the Commissioner to seek relief in court to prevent Highmark from improperly using BCBSD's assets for the benefit of Highmark rather than for BCBSD and its subscribers or otherwise violating relevant laws and the agreements between the parties. *See* 18 *Del. C.* §§ 6311(b)(iii), (b)(iv). HSCA Section 6311(c) also anticipates ongoing oversight by the DOJ insofar as whenever BCBSD must seek approval from the Commissioner for any activity described therein, simultaneous notice must be provided to the DOJ; however, this provision relates only to those areas in which the DOI and the DOJ share concerns, and it does not encompass all areas of potential concern to the DOJ, *e.g.*, as reflected, among other places, in the Conversion Act.

As demonstrated by the emphasized text quoted above, the HCA standards for approval by the Commissioner of a change of control relevantly provide protections for the public where the change of control is likely to be "hazardous or prejudicial" to the could seek the intervention of the Court of Chancery, even if there were no change in the certificate of incorporation (and even if there were no notice requirement under HSCA Section 6311).

The Conversion Act includes "a disposition of reserves" as a trigger requiring the DOJ's review, and HSCA Section 6311 requires that notice be given to the DOJ as well as the DOI in connection with certain expenditures or transfers of funds to the controlling entity. HSCA Section 6311 limits the DOI's review and approval to "the commercial reasonableness of the proposed expenditure or transfer." *See* 18 *Del. C.* §6311(b)(ii). The DOJ's duty to protect the public interest in such reserves is not similarly limited.

The reserves or assets of BCBSD accumulated through the public's subsidy of BCBSD also must be preserved for the benefit of the citizens of Delaware in anticipation of a possible future conversion of BCBSD to a for-profit entity or in the unlikely event BCBSD is ever dissolved. A foundation is required under the Conversion Act to preserve this subsidy upon a conversion, and the DOJ has the duty, and reserves its rights, to protect the charitable trusts and assets of BCBSD held for the public benefit in the State if and when a conversion, as defined in the Conversion Act, occurs. HSCA Section 6311 provides that a not-for-profit health service corporation undergoing a dissolution will distribute its remaining assets to such a foundation as well. The DOJ has a responsibility to ensure that the reserves or assets accumulated through the public's subsidy are preserved for if or when either a conversion or a dissolution occurs.

This statutory framework taken as a whole thus recognizes that the DOI's interest in the financial solvency of BCBSD as an insurer, its policyholders and the insurance buying public differs from the DOJ's interest in protecting the interests of the citizens of Delaware – both their economic and physical health and well-being and the assets accumulated over many decades in BCBSD through the public's subsidy of it as a not-for-profit entity.

b. The Preservation of the Publicly Subsidized BCBSD Assets Necessitates Imposition of a Protective Condition if the Proposed Affiliation is to be Approved.

As stated, the DOJ opposes the Proposed Affiliation, and will recommend disapproval unless the DOJ's proposed protective condition is imposed to preserve for the people of Delaware, who subsidized them, the assets or reserves of BCBSD attributable thereto. The special nature of not-for-profit healthcare entities, and the need to protect the public assets of such entities, has been specifically recognized in Delaware in the Conversion Act, which codified the role of the DOJ in previous transactions involving proposed and actual changes in control of BCBSD prior to the enactment of the Conversion Act. The special nature of such entities has also been recognized in many other jurisdictions in the context of similar conversion legislation, the similarly close scrutiny by State attorneys general of mergers and conversions involving Blue Cross and Blue Shield entities, and the common law actions brought by State attorneys general to protect the public assets represented by such entities.[3]

As was recognized in the testimony of the DOJ expert witnesses in the hearing to consider BCBSD's prior affiliation with CareFirst, Inc. ("CareFirst"), there are at least four ways to move assets among affiliated not-for-profit health service corporations: direct transfers, mismanagement, expense allocation and the movement of revenue or policies from one entity to another.[4] Concerning direct transfers, the DOJ remains concerned that the $500,000 threshold contained in HSCA Section 6311(b)(ii) may prove insufficient to protect the assets of BCBSD attributable to the public subsidy of the company from diversion by Highmark. BCBSD and Highmark have argued that although Highmark will be the sole member of BCBSD, Highmark will not have a "membership interest" in BCBSD (as such term is defined by 8 *Del. C.* § 114(d)(2)) and therefore will not be entitled to dividends or other distributions. Control will indisputably shift to Highmark, however, and dividends and distributions are not the only ways that

[3] For example, State attorneys general have brought actions to protect charitable assets of converting Blue Cross and Blue Shield companies in connection with the conversions of Blue Cross and Blue Shield of Kansas, Community Mutual Insurance Corporation (Ohio) and Blue Cross and Blue Shield of Kentucky. Statutory codifications of foundation requirements currently exist in the conversion laws of, among others states, California, New York and New Jersey.

[4] *See* Testimony of Donna Novak, Hearing Transcript, *In the Matter of Blue Cross Blue Shield Number 99-09*, pp. 386-387.

assets could be diverted, especially over time. As the entity that will control BCBSD, Highmark will have substantial leverage over BCBSD's new Board of Directors, and substantial leeway to allocate costs, revenues, and business among the affiliated entities within the Highmark group.

BCBSD and Highmark claim that any other access by Highmark to BCBSD's assets would be subject to Form D approval by the DOI under the HCA. The HCA requires prior approval of the DOI only for certain enumerated transactions set forth in 18 *Del. C.* § 5005(a)(2), however, and even those can be subject to various minimum thresholds. Highmark further asserts that it has no need or plans to access any of BCBSD's assets, yet need is not necessarily a prerequisite, nor is there any guarantee that Highmark's needs or plans might not change in the future, necessitating from Highmark's perspective access to assets of this controlled affiliate. Moreover, the DOI, which is charged with protecting BCBSD and its policyholders, but not necessarily the public's subsidized assets represented by BCBSD, might well approve affiliate transactions not anticipated today without regard to the effect on BCBSD's public benefit asset, which is not subject to DOI protection.

The potential for unwarranted movement of funds by expense allocation, also noted by the financial experts in CareFirst, is of particular concern here as no cost allocation methodology or formula exists with respect to the Administrative Services Agreement, and the expenses and allocation methodology will be set and controlled by Highmark. Furthermore, Highmark acknowledges that it is continually seeking ways to lower its own cost structure. In the absence of continuing oversight as to the fairness of the cost allocation methodologies and formulae, there is no guarantee that a portion of the assets of BCBSD, including assets attributable to the Delaware public's subsidy of BCBSD, will not be withdrawn from BCBSD as service fees.

Finally, the HCA, under which the Proposed Affiliation is being reviewed by the DOI, provides that the acquisition of control shall be approved unless "the plans or proposals which the acquiring party has...to make any other material change in [the insurer's] business or corporate structure or management, are unfair and unreasonable to policyholders of the insurer and not in the public interest." 18 *Del. C.* § 5003(d)(1)d.

The DOJ is not satisfied that the changes in BCBSD's corporate structure, particularly with regard to Highmark's increasing ability over time to control BCBSD's Board of Directors, is in the public interest of Delawareans, as decisions concerning BCBSD's business and the assets representing the Delaware public's subsidy of BCBSD will all be controlled by Highmark after the affiliation.

c. Requiring the Protection of the Publicly Subsidized BCBSD Assets in a Foundation is an Appropriate Condition.

As discussed above, the DOJ is opposed to the Proposed Affiliation because Delaware will lose control of BCBSD and also because that loss of control raises a serious concern about how the assets attributable to the public's subsidy of BCBSD will be protected if the Proposed Affiliation is effected. If such assets are to be protected, the funds cannot remain subject to the control of BCBSD once BCBSD becomes controlled by Highmark. Protection of these assets can be assured only if they are preserved for use solely for the benefit of the Delaware public.

There are no prohibitions against requiring assets of BCBSD upon a change of control to be transferred into a foundation devoted to serving the unmet health needs of Delaware. The HCA standards under which the DOI's review is being conducted does not address, and certainly does not preclude, the possibility of a foundation for that purpose in such a transaction, nor is the funding of a foundation a "dissipation or improper use" of such assets.

Historically, the concern of State attorneys general with respect to changes of control of not-for-profit health service corporations has most frequently been seen in the context of for-profit conversions; the concern, more precisely, has been that the new ultimate controller(s) of the public benefit assets will not use them solely for the benefit of the public that subsidized the not-for-profit entity. That concern was voiced at the time of the CareFirst affiliation, too, which also was not a conversion, and the DOJ's concern is exactly the same in this instance.[5] In precedent for-profit conversions, the

[5] *See* Testimony of Attorney General Brady, Hearing Transcript, *In The Matter of Blue Cross Blue Shield Number 99-09*, pp. 368-370.

solution generally has been to place stock or funds in a foundation separate from the entity that is becoming controlled.[6] As the DOJ's current concern as to control is the same, the same protective action is appropriate. The assets accumulated through the Delaware public's subsidy of BCBSD must not be under Highmark's control in Pennsylvania. The only way to truly safeguard these funds for Delawareans in fulfillment of their original purpose is to place them in a Delaware foundation which will actively use them for the public benefit of the citizens of Delaware.

d. A Foundation Based on the Parameters Set Forth in 29 *Del. C.* § 2533 is an Appropriate Way to Implement the Condition to Protect the Publicly Subsidized BCBSD Assets.

The Conversion Act requirements for how a foundation must be created, funded and governed were designed to do an optimal job of protecting the "public benefit asset" or assets attributable to the historic public subsidy of a not-for-profit health service corporation entity. They provide an excellent blueprint that has been approved by the Delaware legislature. The foundation's purpose would be serving the State's unmet health needs, and it would be managed by a group of experienced and independent directors. Such a foundation would protect and ensure that the assets accumulated through the Delaware public's subsidy of BCBSD will be properly supervised, managed and ultimately returned to the citizens of Delaware. Although it may not be the only way to achieve this objective, the DOJ believes that a foundation that conforms to the parameters in the Conversion Act is the best way to protect the publicly subsidized BCBSD assets.

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[6] For example, in connection with its acquisition by Anthem Insurance Companies, Inc. ("Anthem"), Blue Cross and Blue Shield of Colorado, Inc. ("BCBSCO") converted to a for-profit stock insurance company all of the stock of which was purchased by Anthem. The proceeds from the sale of BCBSD's stock were placed in a foundation to benefit the health of the citizens of Colorado. Similar foundations were established in Anthem's acquisitions of Blue Cross and Blue Shield of Maine and Blue Cross and Blue Shield of New Hampshire.

IV. CONCLUSION

As stated, the DOJ opposes the Proposed Affiliation because it will transfer control of BCBSD out of Delaware to Pennsylvania and because it will not adequately protect the publicly subsidized assets of BCBSD. The DOJ will recommend disapproval unless BCBSD and Highmark are required to establish the mechanism proposed by the DOJ to guarantee that such assets remain in Delaware to be held and protected for the benefit of Delawareans. It is the DOJ's firm position that this is the only means by which the assets representing the public's subsidy of BCBSD can be adequately preserved and protected after the affiliation has effected a change of control of BCBSD.

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